

For Departmental use only

**SERVICE TAX**  
**AUDIT MANUAL**  
**2011**  
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DIRECTORATE GENERAL OF AUDIT  
CUSTOMS, CENTRAL EXCISE AND SERVICE TAX  
C.R.BUILDING, I.P.ESTATE  
NEW DELHI

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**CHAPTER 1**  
**INTRODUCTION**

- 1.1 The Service Tax Audit Manual outlines procedures to be adopted for conduct of Audit of Service Tax Assessee under Chapter V of the Finance Act, 1994 (as amended from time to time) and the rules framed there under. This ensures that the Audit is carried out in a uniform, efficient and comprehensive manner in accordance with audit standards. In order to make best use of the Manual, the Auditor must study Assessee Master File, previous Audit Reports including Cost Audit Reports, if any, Final Accounts of the Assessee including Trial Balance, Contracts entered into by taxpayers, changes in the Service Tax Law and Procedures, Board's instructions and Circulars, relevant case laws etc.
- 1.2 If during the audit, it is seen that the guidelines in this manual are in conflict or are inconsistent with the provisions of the Chapter V of Finance Act, 1994 (as amended) and / or the Rules framed under Section 94 thereof or any of the Notifications / Circulars / Instructions issued by the Board, because of any changes in the law and policy subsequent to the issue of this manual or otherwise, the provisions of the Act / Rules / Notifications / Circulars / Instructions of the Board will obviously prevail over the contents of this manual.
- 1.3 Any suggestions for amendment / improvement in the Service Tax Audit Manual may be sent through the jurisdictional Commissioners to the Directorate General of Audit, New Delhi.

**CHAPTER 2**  
**MANAGEMENT OF SERVICE TAX AUDIT**

2.1 Audit management requires planning and effective execution of the audit process. Structurally and functionally, this is to be undertaken at two levels – apex level and local level. In order to monitor, co-ordinate and guide the effective implementation of the new audit system, the Board has set up the Directorate General of Audit as the nodal agency. At the local level, management of audit is entrusted to Commissionerates that are supervised by Chief Commissioners.

**2.2 MANAGEMENT AT APEX LEVEL**

2.2.1 The Directorate General of Audit, Customs & Central Excise, New Delhi (headed by Director General) with its 7 Zonal Units at Ahmedabad, Bangalore, Chennai, Delhi, Hyderabad, Kolkata and Mumbai (all headed by an Additional Director General) is required to ensure the effective and efficient implementation of the audit system (based on EA 2000 methodology) as well as to evolve and improve audit techniques and procedures through periodic review. With the help of its Zonal units, the Directorate General of Audit regularly monitors Service Tax audits conducted by the Commissionerates to see that the coverage of taxpayers is adequate in number and reflective of their risk profile as well as to ensure that these audits are conducted in accordance with the letter and spirit of EA 2000 methodology. For this purpose, it needs to interact closely with Chief Commissionerates and Commissionerates for eliminating the deficiencies and improving the Audit performance.

2.2.2 In its advisory role to the Board, Directorate General of Audit is required to suggest measures to enhance tax compliance, to gauge the level of audit standards and the taxpayers' views on the prevalent audit system. It should also interact with select taxpayers for taking a holistic view of the internal audit to formulate proposals which remove irritants and obviate the scope for irregularities.

## **2.3 ROLE OF ZONAL CHIEF COMMISSIONERS**

2.3.1 The office of Chief Commissioner is not an operational formation for the actual conduct of audit, but it provides an important link between the Directorate General of Audit and the Commissionerates of the zone. The role of this office in the overall management of audit is as follows:

- i) Collection, compilation and analysis of the data received from Commissionerates and communication of the same to the respective Zonal Additional Director General (Audit) and to Director General (Audit) wherever specifically asked for.
- ii) Review of the performance of the Commissionerates vis-à-vis audit targets fixed.
- iii) Dissemination of information pertaining to audit to the Commissionerates.
- iv) Resolving local level problems in implementation of audit system and providing feedback to Directorate General of Audit.
- v) Implementation of guidelines pertaining to the zonal Commissionerates issued by Directorate General of Audit.
- vi) Monitoring the training for auditors and the officers of the zone in techniques of service tax audit and accountancy.
- vii) Arranging assistance and information to officers of Directorate General (Audit) in regularly examining the conduct of audit and results.

## **2.4 MANAGEMENT AT LOCAL LEVEL**

2.4.1 For management of audit at local level, the Commissioner should constitute audit parties comprising officers with requisite experience and expertise to conduct Service Tax audits. Planning, Monitoring and Evaluation of Audits should be done by the existing Audit Cell within the Internal Audit Section of the Commissionerate as is the case with the Central Excise audits. All the other steps involved in the conduct of audit would be the responsibility of respective audit parties.

## 2.4.2 Functions of Audit Cell

### 2.4.2.1 Planning of Audit:

- (i) To maintain a database of available manpower resources for effective deployment.
- (ii) To maintain data of taxpayer to be audited mandatorily and others to be audited on the basis of risk analysis.
- (iii) Selection of taxpayers on the basis of Risk parameters, Board's guidelines and available manpower.
- (iv) Maintenance of Assessee Master File
- (v) Planning the audit schedule in such a way so as to make optimum use of available resources.
- (vi) Ensuring proper desk review before commencement of audit.
- (vii) Ensuring audit follow-up.
- (viii) Preparation and submission of reports prescribed by the Directorate General of Audit.
- (ix) Evaluation and scrutiny of working papers.

### 2.4.2.2 Monitoring of Audits.

For monitoring of audits, the Commissioner should convene a Monitoring Committee Meeting (MCM) at least once a month headed by the Commissioner which should be attended by the Additional / Joint Commissioners, officers of the Audit Cell, Supervisory Officers of the Audit Teams, the concerned Divisional Deputy/ Assistant Commissioners. Prior intimation of the meeting is also required to be given to the Zonal ADG (Audit) to enable his representative to be present during the MCM.

The MCM should examine the sustainability of each draft audit objection and set out the future action points in the circulated minutes, which would be drawn and forwarded to the concerned field-officer along with the copy of relevant

audit report. It should also examine the overall working of the audit system and identify the areas requiring special attention including training requirement.

#### 2.4.2.3 Performance Appraisal and Quality Assurance

The Audit cell should put up the Working Papers and Audit Report on each audit for monthly evaluation and scoring. The emphasis of the scoring system would be on conduct of audit in accordance with the norms laid down in this manual and the Working Papers, and also the results achieved. The Scoring system divides the entire process of audit into six parts:

- (i) preparation of the Audit Plan;
- (ii) conduct of audit;
- (iii) revenue points detected (major objections and their quality);
- (iv) realisation of revenue;
- (v) issues relating to future compliance by the taxpayer; and
- (vi) timely completion of audit.

A greater responsibility, therefore, rests on the senior officers to duly assess the audit reports and bring out the strength and weaknesses. Such regular appraisal would help in steering the audit into areas, which are the core of the new audit system, by making good the deficiencies noticed. The scores of each team in different areas of audit should be reviewed every quarter. If the quarterly average in a specific field is found to be below 60 per cent marks, immediate re-training of the concerned auditor for the subject should be organised. The cell should discreetly gather views from the trade/ industry regarding the system of audit. Standard feedback format should be designed by the cell for this purpose. The conclusions and report of the cell should be an input for taking responsive measures.

## 2.5 **ROLE OF SENIOR OFFICERS**

### 2.5.1 **Commissioner**

- (i) Holding Monitoring Committee Meeting (MCM), once a month.
- (ii) Taking a decision about the acceptability of all audit objections.
- (iii) Ensuring that requisite follow-up action (e.g. issue of show cause notice, recovery) is taken (on objections that are accepted) by the Division or other sections of the Commissionerate.
- (iv) Reviewing audit performance at local level and taking steps for improvement.
- (v) Scoring and evaluation of working papers and Audit Reports.
- (vi) Taking remedial measures on the report of Audit Cell on Performance Appraisal and Quality Assurance.
- (vii) Reviewing the performance and participation of the Additional/ Joint Commissioner and Deputy/ Assistant Commissioner of Audit wing.
- (viii) Interacting with the major taxpayers in order to obtain feedback on the audit system.
- (ix) Coordination with AGCR's office.
- (x) Assess the training needs of the auditors and organize training programmes.
- (xi) Submission of periodical reports to various formations including Zonal ADG (Audit) or Director General (Audit) as prescribed from time to time.

#### 2.5.2 **Additional / Joint Commissioner (Audit)**

- (i) Co-ordination, planning and overall management of the audit branch.
- (ii) Interacting with taxpayers paying annual revenue of Rupees five crore or above at the time of audit in order to share major audit findings and compliance issues.
- (iii) Final selection of non-mandatory taxpayers on the basis of risk assessment to be audited during the year.
- (iv) Approving the Desk Review and Audit Plan after ensuring that all the steps have been completed.
- (v) Scoring and evaluation of audit reports.



- (vi) Organizing training programmes for auditors.
- (vii) Review the follow-up actions.

**2.5.3 Deputy / Assistant Commissioner (Audit)**

- (i) Co-ordination, planning and day-to-day management of Audit section.
- (ii) Preparing the list of required minimum number of taxpayers to be audited as per Board's instructions, rupee risk and availability of manpower etc.
- (iii) Preparation of audit schedule with dates for each unit.
- (iv) Supervision and approval of each of the steps leading to preparation of audit plan.
- (v) In select cases, interviewing the officers of the taxpayer during visit for preparing audit plan.
- (vi) Visiting the units and suitably participating in the conduct of audit as frequently as possible especially in sensitive service categories.
- (vii) Scrutinising the draft audit report.
- (viii) Ensuring preparation/ updating of Assessee Master file.
- (ix) Discussion with the taxpayer regarding audit objections in select cases.

**2.5.4 Divisional Officers i.e. Deputy / Assistant Commissioners**

- (i) Provide data to audit branch to build up data base including build up of Assessee master file.
- (ii) Provide the copies of ST-3 returns along with challans and other relevant details.
- (iii) Suggestions regarding selection of units for audit.
- (iv) Discussions with auditors on audit findings prior to preparation of Audit Report by the audit parties.
- (v) Taking follow-up actions on audit objections.
- (vi) Participation in monitoring committee meetings.

#### **2.5.5 Deputy / Assistant Commissioners in-charge of other Sections**

- (i) The Adjudication, Appeal & Review (AA&R) section may provide the details of Orders-in-Original passed by Deputy / Assistant Commissioners, whether accepted or appealed against, once in a month to the Audit Cell for their information.
- (ii) The Legal branch (or AA&R branch) must intimate important Court / CESTAT decisions especially on appeals filed by the department to the audit cell on regular basis.
- (iii) The Technical branch would ensure that copies of general circulars are sent to audit cell and important notifications, which have a bearing on the department's work, are highlighted.
- (iv) The Anti Evasion branch would give the details of all important detections to Audit Cell. In cases where investigations are completed, a copy of the investigation report show cause notice may be provided to Audit Cell.

#### **2.6 AUDIT CELL IN HEADQUARTERS**

The Audit Section in the Commissionerate should have some stationary Audit Parties for attending to office work in the Audit Section. Out of these stationary teams, a few teams may constitute the Audit Cell for providing support to the non-stationary Audit parties as envisaged in this manual.

**CHAPTER 3**  
**AUDITOR'S RESPONSIBILITY AND AUTHORITY**

**3.1 DEFINITION OF AUDITOR**

Service Tax is an indirect tax administered by the Service Tax and Central Excise Department. Accordingly, an 'Auditor' means a Central Excise/ Service Tax officer entrusted with the duty of conducting audit. Normally it will mean an Inspector or Superintendent of Central Excise/ Service Tax.

**3.2 ROLE OF THE AUDITOR**

3.2.1 While conducting audit, the Auditor is required to carry out his duties with utmost sincerity, integrity and diligence. The Auditor has to aim at detection of non-compliance, procedural irregularities and leakage of revenue due to deliberate action or ignorance on the part of the taxpayer. The Auditor should keep in view the prevalent transactional and professional practices, as also the practical difficulties faced by a taxpayer. Therefore, the Auditor should take a balanced, fair and rational approach while conducting the audit. During the course of the audit, if any purely technical infractions, without any revenue implications, are noticed, the Auditor is expected to exercise sense of proportion and should guide the taxpayer in correcting the procedures.

3.2.2. The audit process should be transparent so that the findings are discussed with the taxpayers i.e. service providers / recipients (in case of specified services or under reverse charge mechanism) and an opportunity is accorded to them to give their view-point before an objection is finalised and recovery measures are initiated.

3.2.3 The Auditor should consider the view-point of the taxpayer regarding all points of dispute before taking any definitive stand. Whenever in doubt, the Auditor should contact his supervisor or Assistant / Deputy

Commissioner to ensure that the view taken by him is consistent with established law and procedure.

3.2.4 An Auditor should endeavour to conclude all issues raised by him during a particular audit. He should document all his findings in the working papers so that a record of steps leading to an audit point is available. The working papers for each of the step should be written as soon as that step is completed before proceeding to the next step.

### **3.3 DEALING WITH THE PUBLIC**

3.3.1 The Government's objective is to collect correct amount of tax levied under the Service Tax law in a cost-effective, responsive, fair and transparent manner and also to maintain public confidence in the integrity of the tax system. The audit should be participative and a fact finding mission, as against a fault finding exercise, with the objective of guiding the taxpayer while at the same time guarding against any leakage of revenue.

3.3.2 The Auditor is expected to maintain a good professional relationship with the taxpayer. The Auditor should recognise the rights of the taxpayers, such as the right to impartial and uniform application of law; the right to be treated with courtesy and fairness, the right to information permitted by law and the right to confidentiality of information disclosed only for Departmental audit. Normally the taxpayers have the following advantages from such Audit:-

- (i) They will be better equipped to comply with the Service Tax Law and Procedures;
- (ii) The preparation of ST-3 Return and self-assessment of Service Tax will be better focused and complete;
- (iii) The scrutiny of business accounts and reports/ returns submitted to various agencies, in the course of audit, will help them in removing any deficiencies in their accounting, documentation and internal controls;

(iv) The disputes and proceedings against them would be minimised or even eliminated.

3.3.3 Auditor should use a constructive and tactful approach to gain the goodwill and confidence of the taxpayer. In return, the Auditor can expect the taxpayer to be cooperative and to provide the necessary documents and information. In cases of non-cooperation, deliberate failure to provide information by the taxpayer or any other exigency, the Auditor should inform his superiors and follow it up by a written report, if necessary.

3.3.4 Confidentiality should be maintained in respect of sensitive and confidential information furnished to an Auditor during the course of audit. All records submitted by the service provider to the audit parties, in electronic or manual format, should be used only for verification of levy of service tax and tax compliance. These shall not be used for any other purposes without the express written consent of the taxpayer. Further, the officers should not disclose to outsiders any particulars learnt by them in their official capacity.

#### 3.4 AUDITOR'S AUTHORITY UNDER SERVICE TAX LAW

3.4.1 Service providers of taxable services in the entire country are also required to be audited. The relevant enabling provisions for this are,-

- (i) Section 65(121) of the Finance Act, 1994 provides that words and expressions used but not defined in Chapter V of the said Finance Act and defined in the Central Excise Act, 1944 or the rules made there under, shall apply, so far as may be in relation to Service Tax as they apply in relation to a duty of excise.
- (ii) Rule 2(2) of the Service Tax Rules, 1994 lays down that all words and expressions used but not defined in Service Tax Rules but defined in the Central Excise Act, 1944 and the rules made thereunder shall have

the meanings assigned to them in that Act and Rules. [Notification No.2/94-ST, dated 28.06.1994]

- (iii) The definition of "Central Excise Officer" as contained in the Section 2(b) of the Central Excise Act, 1944 will also apply to the Central Excise officers conducting Service Tax audit and shall also include Service Tax officers. Thus, a Central Excise officer assigned the duties of Audit in Service Tax is a proper officer for conduct of Service Tax audit.

3.4.2 Vide Service Tax Circular No.775/8/2004-CX, dated 17.02.2004 (F.No.206/03/2003-CX), the Board directed the audit of all services subjected to levy of service tax. Subsequently, vide Service Tax Circular No.97/8/2007-ST, dated 23.08.2007 [F.No.135/85/2007-CX4], at S.No.11, the Board issued instructions for selective audit of Service taxpayers and other assesses like input service distributors etc.

3.4.3 The Service Tax Law through the Finance Act, 1994 and Service Tax Rules, 1994 do not prescribe any specific records to be maintained by the taxpayer. However, Rule 5 of the said Rules deals with Records. In this regard,-

- (i) Rule 5(1) of the Service Tax Rules, 1994 mentions that the records (including computerised data) as maintained by a taxpayer in accordance with various laws in force from time to time shall be acceptable.
- (ii) Rule 5(2) of the Service Tax Rules, 1994 requires every taxpayer to furnish to the Superintendent of Central Excise, at the time of filing his return for the first time or the 31<sup>st</sup> day of January 2008, whichever is later, a list of all the records prepared or maintained by the taxpayer for accounting of transactions specified therein relating to Service Tax including all other financial records maintained in the normal course of business.

- (iii) Rule 5A(1) of the Service Tax Rules, 1994 empowers an officer authorised by Commissioner to have access to any premises registered under the rules for the purpose of carrying out any scrutiny, verification and checks as may be necessary to safeguard the interest of revenue

Further, under Rule 5A(2) the assessee shall on demand make available to the officer or audit party deputed by the Commissioner, within 15 days, (i) the records mentioned in Rule 5(2), (ii) the trial balance or its equivalent and (iii) the income tax audit report under section 44AB of the Income tax Act, 1961.

- (iv) Besides, Rules 9(5) and 9(6) of the Cenvat Credit Rules, 2004 provides for maintenance of records by a provider of output service with respect to receipt and consumption of inputs, capital goods and input services in addition to submission of periodical returns prescribed under rule 9(9) to rule 9(11) *ibid* in respect of credit availed.

3.4.4 In view of the above, all records and documents pertaining to the business of rendering taxable service and records relating to availment of credit, including computerised accounts, can be appropriately examined by the officers while conducting audit.

## **CHAPTER 4**

### **PRINCIPLES OF AUDIT**

4.1 The objective of audit of service providers is to measure the level of compliance of the taxpayer in the light of the provisions of Chapter V of the Finance Act, 1994 and the rules framed thereunder in terms of Section 94 of the Act *ibid*. It should be consistent with departmental instructions and make use of professional audit methodology and procedures. The basic principles are:

- The audit should be conducted in a systematic and penetrative manner.
- Emphasis should be on the identified risk areas and on scrutiny of records maintained in the normal course of business.
- Audit efforts should be based on materiality i.e. degree of scrutiny will depend on the nature of risk factors identified.
- Recording of all checks and findings.
- Audit should be normally distinct from anti-evasion operation in as much as it can detect irregularities only to the extent of their reflection in the books of accounts.

#### **4.2 STANDARDS FOR CONDUCT OF AUDIT**

4.2.1 In keeping with the principles of audit outlined above, Service Tax audit has to be conducted in a transparent and systematic manner with focus on business records of the taxpayer according to the audit plan for each taxpayer. The taxpayer's participation in the course of audit is also envisaged so that instead of purely technical and explainable objections (without any revenue implications), the focus is kept on substantive issues.

4.2.2 The auditor should ensure that audit is conducted in a focused manner with optimum utilisation of time and resources available in hand. The auditor must use judgement and experience to determine the materiality of any discrepancies and/or irregularities observed and decide what action is necessary under the circumstance, for example,



(i) Cumulative effect of small items: An error of one isolated item might be insignificant but the cumulative effect of many individually unimportant items would signify systematic failure. In fact, the relative materiality of an individual item has to be viewed against the net total effect on over-all compliance and revenue interest.

(ii) General or Particular Items: An error made in a particular transaction may be an aberration if it is a stray single instance but the effect may be material, if it is of recurring nature. Thus frequency of error is of importance.

(iii) Effect in relation to scale of a taxpayer's operation: An error by itself may appear small but may have sizable implications due to the huge scale of an taxpayer's operations.

#### 4.3 PERIOD TO BE COVERED DURING AUDIT

Every audit should invariably cover the retrospective period up to the previous audit by the Departmental Audit Party or the last 5 years (limited to the commencement of levy on a particular service) whichever is less and should extend up to the last completed Financial Year preceding the date of commencement of the audit.

#### 4.4 DURATION OF AUDIT

4.4.1 Efforts should be made to complete each audit within the following general time limits:-

- (i) Taxpayers with Service Tax payment above Rs.3 Crores (Cash + CENVAT) **(mandatory taxpayers) – upto maximum 10 working days.**
- (ii) Taxpayers with Service Tax payment between Rs.1 Crore and Rs.3 Crores (Cash + CENVAT) – upto **maximum 7 working days.**
- (iii) Taxpayers with Service Tax payment between Rs.25 Lakhs and Rs.1 Crore (Cash + CENVAT) – upto **maximum 5 working days.**
- (iv) Taxpayers with Service Tax payment upto Rs.25 lakhs (Cash + CENVAT) – upto **maximum 3 working days.**

4.4.2 The duration, as above, covers the effective number of working days spent by the Audit party for the audit of a particular taxpayer from Desk Review to preparation of report of audit results (i.e. days spent in office as well as in the taxpayer's premises). In exceptional cases, the aforesaid period may be extended with the approval of Deputy/ Assistant Commissioner (Audit). Further, in accordance with the requirements of the audit of a particular taxpayer such duration can suitably be reduced with the express prior concurrence of the Deputy/ Assistant Commissioner (Audit) provided the verification as per the Audit Plan has been completed in the prescribed manner.

#### 4.5 STAGE WISE ACTION FOR AUDIT

Preparation and updating of Assessee Master file containing comprehensive taxpayer profile.

- (i) Preparation and updating of Assessee Master file containing comprehensive taxpayer profile.
- (ii) Selection of taxpayers for audit.
- (iii) Collection of all relevant documents, data reconciliation statement and reply to questionnaire.
- (iv) Interview of the taxpayer.
- (v) Desk review on the basis of relevant documents and interview of the taxpayer.
- (vi) Formulation and approval of audit plan based on desk review.
- (vii) Conducting Audit Verification on the basis of the approved Audit Plan.
- (viii) Apprising the taxpayer of the irregularities noticed, and ascertaining his view point and advising him to deposit the amount detected during audit so as to avail the facility available under Section 73(3) of the Finance Act, 1994.
- (ix) Suggestions to taxpayer for future correction/ improvements.

- (x) Preparation of draft audit report and its submission to the senior officers.
- (xi) Monitoring of the draft audit report during MCM and approval of the objections raised.
- (xii) Scoring of Audit Report.
- (xiii) Issue of final audit report.
- (xiv) Preparation of Modus Operandi Circular to be submitted to the Zonal Additional Director General (Audit) and the Directorate General of Service Tax.
- (xv) Follow up action, for monitoring the compliance of various points.
- (xvi) Ensure timely issuance of SCNs wherever warranted.
- (xvii) Recovery of revenue detected.

**CHAPTER 5**  
**SELECTION OF TAXPAYERS FOR AUDIT**

5.1.1 Selection of taxpayers for audit means selection of taxpayers to be audited during a specified period taking into account available resources. Given the large number of registered taxpayers under Service Tax, it is impossible to subject every taxpayer to audit each year with the available resources. Also mere emphasis on coverage of more number of taxpayers would also dilute the quality of Audit. Proper selection of units based on scientific techniques and experience will help in effective deployment of available resources for achieving optimum results.

5.1.2. Notwithstanding the above principle, there are certain types of taxpayers (depending on the quantum of annual Service Tax payment) which are to be audited mandatorily within a given span of time. Thus, taxpayers whose annual service tax payment (including cash and CENVAT) was Rs.3 crore or more in the preceding financial year may be subjected to mandatory audit each year. It is preferable that Audit of all such taxpayers is done by using Computer Assisted Audit Program (CAAP) techniques. The frequency of audit for taxpayers, categorized as Type A, B, C & D, would be as per following norms:-

- (i) Type A - Taxpayers with Service Tax payment above Rs.3 Crores (Cash + CENVAT) (**mandatory taxpayers**) – to be audited every year.
- (ii) Type B - Taxpayers with service Tax payment between Rs. 1 Crores to Rs. 3 Crores (Cash+CENVAT) - to be audited once every two years.
- (iii) Type C - Taxpayers with Service Tax payment between Rs.25 Lakhs and Rs.1 Crore (Cash + CENVAT) – to be audited once every five years.

- (iv) Type D - Taxpayers with Service Tax payment upto Rs.25 lakhs (Cash + CENVAT) – 2% of taxpayers to be audited every year.

Vide para 13.1 of JS (TRU-II)'s DO letter F.No. 334/3/2011-TRU, dated 28.02.2011, the Hon'ble Finance Minister has announced in his Budget speech (2011) in respect of Service Tax that, - individual and sole proprietor assesseees with a turnover up to Rs. 60 lakhs shall not be subject to audit

5.1.3. The Audit selection guidelines, therefore, would apply to the non-mandatory taxpayers, forming part of the discretionary workload. These taxpayers should be selected on the basis of assessment of the risk potential to revenue. This process, which is an essential feature of audit selection, is known as Risk Assessment. It involves the ranking of taxpayers according to a quantitative indicator of risk known as a 'risk parameter'. It is also suggested that the taxpayers whose returns were selected for detailed scrutiny, may not be taken up for Audit that year, to avoid duplication of work. Similarly the taxpayers who have been selected for Audit, the detailed scrutiny of their ST-3 Returns need not be taken up during that year.

#### 5.1.4 **Method of selection of taxpayers based on risk assessment**

The selection of taxpayers for audit should be carried out for the entire year at the beginning of the financial year. For this, the following steps may be followed in sequence:

- Preparation of updated list of all registered taxpayers of the Commissionerate falling under different tax slabs (Cash + CENVAT) i.e. above Rs.3 crores, between Rs.1 crore and Rs.3 crores, between Rs.25 lakh and Rs.1 crore and below Rs.25 lakh.
- Deciding upon the maximum number of audits that can be carried out in different tax slabs in non-mandatory categories taking into account:
  - 1) the instructions of the Board,
  - 2) the available man power in audit section, and
  - 3) available audit man-hours after conducting the mandatory audits.
- It is desirable that the risk parameters calculations are done on a segmented basis for each duty segment covering the non-mandatory taxpayers. The duty segments could be as per above four segments, and then a list of taxpayers in descending order of rupee risk should be arranged within each duty segment.

- Working out of Rupee Risk ( $S_1$ ) as prescribed in paragraph 5.1.5 below. In absence of proper database and lack of details in the Assessee Master File, selection could be made on the basis of risk parameter  $S_2$  as prescribed in paragraph 5.1.6. Local risk parameters as discussed below can also be combined with  $S_1$  or  $S_2$  to select taxpayers having high risk perception in the opinion of the Commissioner.
- Working out local risk parameters may also be done by the respective Commissionerate on the basis of various parameters. An illustrative list of the same is as below:
  - a) Taxpayers paying high proportion of service tax through CENVAT.
  - b) Taxpayers having Centralised registration
  - c) Taxpayers providing both exempted as well as taxable services.
  - d) Taxpayers providing services of personal nature which are being consumed directly and therefore there being no use of CENVAT to the consumer.
  - e) Taxpayers which are registered for multiple services.
  - f) Taxpayers referred to by the Division/ Range on the basis of Scrutiny.
  - g) Taxpayers whose earlier audit resulted into substantial demand.
  - h) Taxpayers referred to audit as a result of the scrutiny of their half yearly returns.
  - i) Taxpayers providing services to Associated concerns.
  - j) Tax payers receiving inputs, input services, capital goods etc., free of cost from service receivers or on their behalf.
  - k) Taxpayers having bad track record with the Department.
  - l) Taxpayers taking credit on the basis of documents issued by input service distributor.
  - m) Taxpayers whose value of taxable service exhibits a downward trend.
  - n) Taxpayers engaged in export of services.
  - o) Services where service tax is payable under reverse charge mechanism.

- Preparation of final annual lists of taxpayers selected for audit by applying the prescribed risk parameters together with local risk parameters. In doing so, tax payers should be selected in descending order of their risk perception keeping in mind the availability of manpower.

#### 5.1.5 Computation of risk parameter $S_1$ :

The Rupee Risk  $S_1$  can be calculated for all non-mandatory taxpayers using the following formula:

$$S_1 = (V_1 - V_2) \times r / (100 + r)$$

Where

$V_1$  = Gross receivable including ST as per ledger or gross income including ST as per P&L A/c but excluding value of excisable goods sold.

$V_2$  = Taxable value including ST as per ST-3 Return.

$r$  = Rate of Service tax in percentage.

Note: If ledger details are not available, then only data from Annual Report (P & L A/c) or Trial Balance can be taken for calculation of  $V_1$ .

All the non-mandatory taxpayers should be arranged in the descending order of rupee risk and included in the audit schedule in that sequence.

#### 5.1.6 Computation of risk parameter $S_2$

If due to some unavoidable reason, it is not possible to compute the risk parameter  $S_1$ , only then  $S_2$  should be used for selection of non-mandatory tax payers.  $S_2$  can be arrived at in the following manner:

$$S_2 = (0.25 \times R_1) + (0.15 \times R_2 \times V) + (0.15 \times R_3 \times V) + (0.10 \times R_4 \times V) + (0.10 \times R_5 \times V) + (0.10 \times R_6 \times V) + (0.10 \times R_7 \times V)$$

Where

$R_1$  = Total recoverable amount as per the Table for determination of Short Payment of Revenue on the basis of ST-3 [ see ANNEXURE – I ]

$R_2$  = Change in (total credit taken / total value of taxable service charged).

$R_3$  = Change in (ST paid by CENVAT / total service tax paid).

$R_4$  = Change in (cumulative value charged / cumulative value received for Taxable Service).

$R_5$  = Change in (Value of exempted service / value of taxable service).

$R_6$  = Change in (amount of abatement claimed / total value of taxable service).

$R_7$  = Change in (amount received against export of service / amount received against taxable service).

$V$  = Total Value of Taxable Service.

Risk Parameter  $S_2$  in conjunction with local Risk Parameters can be used for selection of non-mandatory taxpayers in absence of  $S_1$ . The change (absolute value of change) in various parameters listed above should be taken from the two ST-3 Returns of the last completed financial year under audit. The worksheet [ see ANNEXURE – I ] also contains a sheet for checking of CENVAT Credit utilized by the taxpayer. It may be noted that selection of taxpayers on the basis of  $S_2$  should be resorted to only whom  $S_1$  can not be ascertained.

## 5.2 PREPARATION OF AUDIT SCHEDULE

5.2.1 The selection of taxpayers for audit should be done at the beginning of the financial year for the whole year. The list of taxpayers so chosen shall form the basis for preparation of audit schedule. While preparing the schedule, care should be taken to ensure that all taxpayers to be audited mandatorily during the year are covered. As regards remaining taxpayers, it is suggested that a schedule of taxpayers to be audited should be prepared in such a manner that high-risk taxpayers are placed



at the top. This will ensure that in the event of time overrun in conducting some of the audits, only the low risk taxpayers are left unaudited. Normally, the final audit schedule is prepared on a quarterly basis. However, it is desired that the list of

taxpayers to be audited in the whole financial year should be identified in the beginning of the financial year itself. Keeping a target of audit of at least 3 Taxpayers each month (consisting of taxpayers of various categories), by each Audit Group, a list of Taxpayers to be audited by each Audit Group in a whole year could be given to each Audit Group. This would give them sufficient time to obtain the information from the Taxpayers, which is otherwise one of the causes of delay in conduct of audit.

In the Service Tax Commissionerates where assessee is also a manufacturer, there will be coordination between the Service Tax Commissionerate and the Central Excise Commissionerate. As regards to the audit of manufacturer who is also the service provider, as far as possible, simultaneous audit for Central Excise and Service Tax (in composite Commissionerates) should be undertaken. The Service Tax audit team should collect all the relevant documents required for desk review and reconciliation and complete all the steps required for audit prior to Audit Verification. However, the Audit Verification at the premises of the taxpayer should be done by the Central Excise Audit Party and the Service Tax Audit Party simultaneously.

#### **5.2.2 Service Tax Audit Cell in the Audit Sections**

The audit section in each Commissionerate should have a separate Service Tax Audit Cell. The said Cell should comprise of officers with proven track record and knowledge of Service Tax Law and procedures together with current audit techniques. Educational qualifications of an officer should also be factored in for such selection. Efforts should be made to arrange special training programmes with regard to Service Tax audit techniques, peculiarities of major taxable services and risk factors unique to important service categories so that auditors have the necessary knowledge and insight. Allotment of service providers for audit should be done for the whole Financial Year well in advance so as to give enough time for auditors to prepare background material and familiarise themselves with the relevant service.

### **5.3 ALLOCATION OF AUDIT**

It is desirable that the total number of officers available for Audit is divided into Audit Parties. There after the Services may be divided into groups by aggregating similar services. A suggested list of such groups is provided in **ANNEXURE - II**. This grouping would facilitate specialization amongst the Audit Officers and would also lead to uniformity in the type of objections that are raised to particular service providers. However, Audit groups can be reconstituted in accordance with the local needs.

### **5.4 DEPLOYMENT OF AUDITORS**

5.4.1 Normally, officers selected and posted to Service Tax Audit should be allowed to continue for a minimum period of 3 years.

5.4.2 Generally, each audit party may consist of two Superintendents, one Inspector and suitable ministerial assistance. The senior most Superintendent should lead the audit party. In cases of heavy workload (in view of number of transactions, their complexity and connected matters) the number of officers in an audit party may suitably be increased by temporarily merging two or more Audit Parties. The supervisory officer of the rank of Deputy / Assistant Commissioner must frequently associate with the audit verification by attending to select risk areas as identified in the desk review, especially in case of important and sensitive taxpayers. In addition to a minimum advance-notice of 15 days to the taxpayer, every audit party should inform the supervising Deputy / Assistant Commissioner (Audit) (as also the jurisdictional Divisional Deputy / Assistant Commissioner) of the dates of their visit to a service-provider so as to enable them to contact the audit party whenever necessary.

**CHAPTER 6**  
**PREPARATION FOR AUDIT**

**6.1 MASTER FILE ON EACH TAX-PAYER**

6.1.1 Risk assessment-based audit requires a strong database for profiling each taxpayer so that risk-factors relevant to a taxpayer may be identified in a scientific manner and audit is planned and executed accordingly. Some of the relevant data has to be collected from the taxpayer during the course of audit, while the rest is to be extracted from the registration documents and returns filed by the taxpayer as well as from his Annual Report, reports / returns to regulatory authorities or other agencies, Income Tax returns, contracts with his clients, Audit Reports of earlier periods as well as audits conducted by other agencies, (like office of C&AG), etc.

6.1.2 The Audit Cell should collect all relevant information and documents about the taxpayer from various sources (including the taxpayer himself), arrange it methodically and regularly update it. For this, it is necessary to maintain separate Master Files for each Taxpayer registered with the department. The master file should contain all relevant information about a taxpayer in three parts. The first part is the Taxpayer's profile, the second part contains information about the business particulars of the taxpayer and the third part contains the copies of documents such as application for registration, registration certificates, balance sheets, annual reports, previous Audit Report, LAR etc., pertaining to the taxpayer. The information should be in the form of statistical data as well as in narrative form. The format of Master file is given in **ANNEXURE - III** to this manual.

6.1.3 The hard copies of the documents should be maintained for a period of 5 years. Documents pertaining to period older than 5 years should be removed unless relevant to any current proceedings. The disposal of the documents removed from the master file should be done with the approval of Deputy Commissioner / Assistant Commissioner (Audit).

6.1.4 The Audit Cell should maintain a separate electronic folder of each taxpayer and make all entries for that particular taxpayer in that folder only. The folder should be updated after every subsequent audit. However, the Audit Cell shall update the changes, if any, on a half yearly basis. Initially, most of the information would be available in the form of hard copies and the updating has to be done manually. Progressively, the information would be maintained in electronic format with automated data transfer through networking system and could be automatically updated.

6.1.5 The electronic data should be kept in properly secured format so that it can be altered or modified only by the authorised officer of the Audit Cell. The data should, however, be accessible to all the concerned officers. This file would be useful not only for audit but also for other purposes such as generating Management Information System (MIS) reports and replying to Parliament Questions, etc.

6.1.6 The Audit Cell is responsible for the upkeep and update of the master files on each taxpayer. If not already opened, such files should be created immediately. If the same are not available, the same shall be created before the next audit is taken up.

## **6.2 DESK REVIEW**

6.2.1 This is the first stage of the audit exercise done in the office. As soon as the Auditor receives the list of Taxpayers that has to be audited by him, he should immediately write a letter to all of them in the format [see ANNEXURE – IV]. This letter seeks information in the format given in ANNEXURE - XV. A list of documents required for carrying out Desk Review is also included in the said Annexure. This exhaustive list has been prepared so as to assimilate maximum possible relevant information about the taxpayer and his business before visiting his premises.

6.2.2 On receiving the documents along with filled up Questionnaire and reconciliation data sheet in the prescribed proforma, the Audit Group should put them up to Additional / Joint Commissioner (Audit) through Deputy / Assistant

.Commissioner (Audit) after carrying out preliminary reconciliation identifying discrepancies, if any, and carrying out detailed examination of the records and information (including that already captured in the Master File on taxpayer).

6.2.3 For carrying out the detailed analysis, the following points should be kept in mind:-

- a) Check whether the description of the service has been changed during the past three to four years, without affecting the nature of the service provided. To illustrate, a Management Consultant attracting tax under Section 65 (105)(r) of the Finance Act, 1994 may declare himself as a law practitioner attracting tax under Section 65 (105)(zzzzm) of the Finance Act, 1994 without essentially altering the nature of service provided.
- b) The Auditor should check the data provided by the taxpayer for reconciliation with other documents such as gross trial balance, Annual Accounts, Ledgers etc. collected by them and carry out a preliminary reconciliation for the purpose of identifying any amount that might have escaped Service Tax.
- c) Auditor has to be careful when the services are for personal consumption because in such cases, there is a possibility of non-availment of CENVAT by the service recipient or he is not likely to claim expenses as deductions under Income tax. To illustrate, if the individual consumer is not eligible to get CENVAT credit of input tax received because he is not a provider of any taxable output service, he may like to make payment to the service provider in cash. The service provider may also oblige such individual by accepting the consideration in cash without charging service tax, though it will not result in any saving to him so far as service tax is concerned. It may because of any of the following reasons:-
  - i) Savings of Direct Taxes (Income Tax)
  - ii) Making its business more competitive vis-à-vis other competitors.

6.2.4 While looking into the books of Account of the taxpayer, the following points should also be looked into by the Auditor:

- a) In case consideration is received by way of account payee cheques, the Auditor must ensure that the consideration is properly recorded in the books of accounts. Auditor should verify that the name of the bank in which payment has been received is recorded in the account books and is appearing in the balance sheet. Auditor should also verify the Bank Reconciliation Statement prepared by the taxpayer.
- b) In case consideration is received in cash, generally there is no check available for verification of such payment. However, few checks as under may be carried out when amount for services provided or to be provided is received in cash-
- (i) In case of long outstanding balances appearing in the books of account of the assessee, reason for the same must be ascertained from the taxpayer. In other words, ageing of amount receivable must be examined particularly when services are not in relation to business or commerce.
  - (ii) In case of taxable services where material is transferred during the provision of services like construction, outdoor caterer and similar like services, the **ratio of value of material consumed to gross receipts** may be calculated to have a fair estimate of the service tax liability of the taxpayer. **Industry's trend or past record of the taxpayer** in this respect may also prove to be a useful tool in the hands of Auditor.
  - (iii) Auditor should ask for receipts, billing etc. especially if payment is not received at all or in case of bad debts or discounts claimed by the service provider.
- c) Auditor should analyse both debit and credit side of the profit & loss a/c, trial balance, ledgers etc. because it is a myth that while ascertaining the service tax liability of the taxpayer, one has to look only at the credit side of P&L A/c. Debit side is equally important or rather more prone to frauds and errors. Therefore, the auditor needs to pay attention towards debit side also. Debit side is important because of-

(i) Reverse charge mechanism- under this mechanism, the recipient of services is liable to pay service tax (e.g. GTA Services, services received from abroad, etc.). Therefore nothing appears on the credit side of the P&L a/c. However, service tax has to be calculated on the amount paid towards taxable services received.

(ii) Reimbursement- unless the concept of pure agent is applicable, reimbursements are includible in the value of Taxable Service. Reconciliation should cover all receivables including reimbursements, sale of goods etc.

- d) Auditor should check as to whether there is any netting of income with amount payable; e.g. a person is acting as a commission agent and receives commission amounting to Rs.5000/- taxable under the category of Business Auxiliary Services (BAS). He is also engaged in trading of goods wherein he is required to pay a commission of Rs. 3000. It may be possible that the amount of commission appearing in the P&L A/c is only Rs. 2000/-, the detail of which is given in Notes on Accounts or is available from the Gross Trial Balance. In this case, if notes to accounts are not studied properly or the Gross Trial balance is not studied, then the Auditor may not be able to determine the correct value of taxable service rendered by the taxpayer.

#### 6.2.5 Scrutiny of VAT Returns

The VAT Returns should be scrutinized for ensuring that the value of services which attract both service tax & VAT are consistently reported. Some of such services which attract both Service Tax & VAT are:-

- ( i ) Commercial or Industrial Construction Services
- (ii) Complex Construction Services
- (iii) Works Contract Services
- (iv) Annual Maintenance Services
- (v) Outdoor Caterer Services
- (vi) Mandap Keeper Services

(vii) Pandal or Shamiana Contractor Services

(viii) Rent – a - Cab Services

#### **6.2.6 Scrutiny of the Tax Audit Report in Form 3CD [ see ANNEXURE – V ]**

6.2.6.1 Clause 14 of the Tax Audit Report (Form 3CD) provides information about amount of depreciation under Section 32 of the Income Tax Act, 1961 and that of CENVAT credit availed by the service providers on capital goods.

6.2.6.2 Clause 22 of the Tax Audit report (Form 3CD) gives the details of CENVAT Credit claimed by the service provider. It also provides the details of credit available and carried forward to the next year. Hence, the Auditor can authenticate the amount of credit carried forward in the service tax returns with the information provided in terms of this clause.

6.2.6.3 Clause 22 of the Tax Audit Report (Form 3CD) also gives information regarding prior period incomes and expenses booked in the year under Tax audit. The Auditor shall ensure that service tax is paid on these amounts in case they are subject to service tax.

6.2.6.4 Clause 30 of the Tax Audit Report (Form 3CD) provides the information relating to Cost Audit. If such an audit has been carried out, the Auditor should examine the Cost Audit Report.

6.2.6.5 Clause 32 of the Tax Audit Report (Form 3CD) provides the important accounting ratios.

#### **6.2.7 Scrutiny of Tax Deducted at Source (TDS) Certificates**

The total receipts for services can be verified from TDS certificates in the following manner:-



- i. By deducting the amount of service tax from the value on which tax has been deducted at source, the receipts appearing in the books of accounts can be reconciled.
- ii. The nature of services can also be confirmed from these certificates and in case of any discrepancy in the categorization of services under proper head, elaborate checks need to be carried out by the Auditor.
- iii. Details of TDS credit claimed in the Income Tax Return may also be examined.

## **6.2.8 Study of various financial records**

### **6.2.8.1 Notes on Accounts**

In case of debtors, notes indicate debtors which are outstanding for a period exceeding 6 months. Foreign Exchange related transactions are also given in the notes on accounts. Management can use these figures to show book profit to suit their requirements. Netting of amounts of revenue or expenditure can also be resorted to by the management although as per accounting standards it is mandatory to specify the figures separately.

Scrutiny of Notes will also reveal whether there was any change in the system of accounting. For example- a taxpayer changes from cash system of accounting to mercantile accrual system. The notes also indicate the impact of accounting policies on various liabilities including the tax liability of the taxpayer. Therefore, the auditor must read the notes carefully

### **6.2.8.2 Director's Report**

Director's report may, inter alia, contain information about-

- a) Foreign Exchange earned during the year.

- b) Foreign Exchange paid during the year, e.g.- may be on account of taxable services availed by the taxpayer where he is liable to pay service tax under reverse charge mechanism.
- c) Information on the operations carried out by the taxpayer during the year under report. This may help in finding the exact nature of services provided by the taxpayer.
- d) The facts stated in Director's Report should be reconciled with the ST-3 Returns.

#### 6.2.8.3 Statutory Auditor's Report

It is the most important report contained in the Annual Accounts of a Company. The Statutory Auditor Certifies as to whether the books of account of the company are properly maintained or not and also whether there exist internal control mechanism commensurate with the size and extent of business of the company. Any adverse noting of the Statutory Auditor has to be replied by the management of the Company.

#### 6.2.8.4 The Trial Balance

The most important use of Gross Trial Balance is that it contains balances of individual accounts whereas in Balance Sheet and P&L A/c many accounts are grouped together, e.g.,

- a. In the P&L A/c, all the incomes are clubbed together under the head 'Gross Receipts', 'Sales' as the case may be. However, Trial Balance shows income earned under each category of revenue separately.
- b. Not only Trial Balance is important in relation to income side, but it is very important in relation to expenditure side also. For instance- Payment made towards **Sponsorship services** may be clubbed in the category of Advertisement and Sales Promotion Expenses which can be identified only from the Trial Balance.
- c. Similarly, **freight paid** may be clubbed with Purchases or Fixed Assets.

**6.2.8.5** Indicative list of items to be examined in the Trial Balance / Profit & Loss Account / Balance Sheet / Tax Audit Report.

The perusal of the Trial Balance could achieve the following:

- i. Familiarization with chart of accounts/account code and understand as to what extent the information is detailed and integrated with other subsystems; few sample Journal Vouchers may also be seen to understand the information mentioned therein.
- ii. Understand the grouping of sub accounts under main accounts for the purposes of summarization into Profit and Loss account and the Balance Sheet.
- iii. Identification of accounts, which have a prima facie relevance for service tax payment (may be direct or indirect). These accounts may have to be seen in detail at later stage of audit depending upon the result of subsequent audit processes;
- iv. Understand the tax accounting system in so far as it pertains to Service Tax payment and treatment of credit of service tax on input services;

During the study of the Trial Balance/ Profit and Loss Account all income accounts could be studied in detail. Normally, the Profit and Loss Account would show a consolidated entry for business income from all sources. According to accounting standards, non-business income such as interest income or dividend income is required to be shown separately.

To begin with, auditors should call for the groupings of business income shown in the Profit and Loss Account. The said groupings would show the different heads under which the incomes have been accounted for. They should carefully study the nature of business income – some of which may have accrued from the sale of taxable services and the balance from the

sale of non-taxable services. The exact nature of these services may be determined from the supporting documents such as Vouchers, bills or

contracts. In doing so, auditors need to be guided by the nomenclature (used for each of these services) in the Trial Balance or Annexures to the Profit & Loss Account. It is possible that the true nature of the service is obscured or disguised by using a nomenclature that is either non-taxable or exempted.

Through the study of Trial Balance, the Auditor should familiarize himself with chart of accounts/ account codes and understand as to what extent the information is detailed and integrated with other subsystems and a few sample Journal Vouchers may also be seen to understand the information mentioned therein. The Auditor should also understand the grouping of sub accounts under main accounts for the purposes of summarization into Profit and Loss account and the Balance Sheet and understand the identification of accounts, which have a prima facie relevance for service tax payment (may be direct or indirect). These accounts may have to be seen in detail at later stage of audit depending upon the result of subsequent audit processes. He should understand the tax accounting system in so far as it pertains to Service Tax payment and treatment of credit of service tax on input services.

#### **6.2.8.5**      Profit and Loss Account

The auditor is required to examine income and expenditure accounts in the Profit and Loss Account:

**a) Income Accounts:** Normally, the Profit and Loss Account would show a consolidated entry for business income from all sources. According to accounting standards, non-business income such as interest income or dividend income is required to be shown separately. To begin with, auditors should call for the groupings of business income shown in the Profit and Loss Account. The said groupings

would show the different heads under which the incomes have been accounted for. They should carefully study the nature of business income – some of which may have accrued from the sale of taxable services and the balance from the sale of non-taxable services. The exact nature of these services may be determined from the supporting documents such as vouchers, bills or contracts. In doing so, auditors need to be guided by the nomenclature (used for each of these services) in the Trial Balance or Annexures to the Profit and Loss Account. It is possible that the true nature of the service may be obscured or disguised by using a nomenclature that is either non-taxable or exempted.

**b) Expense Accounts:** Scrutiny of expense accounts would enable the Auditor to identify major expenditure heads. In specific terms, such scrutiny may be useful in the following manner:

- i) Useful for verification of out of pocket expenses where deductions for these have been claimed from the value of taxable services.
- ii) Correlation between expenditure head and value of taxable service e.g. fuel expenses and the value of taxable service in the case of tour operators.
- iii) Analysis of trend in total expenses vis-à-vis the previous year to check whether income grew proportionately or not.

6.2.9 The Reconciliation Data Sheet given by the Taxpayer [ see ANNEXURE – VI ] should be analysed along with the Questionnaire [ see ANNEXURE – XV ] submitted by him. These should be compared with the Financial Documents like Balance Sheet, Profit & Loss A/c, Ledger etc. to find out whether there exist any discrepancies and whether there are some areas which have escaped payment of tax. For the benefits of the Auditors, the reconciliation format is provided at ANNEXURE – VII to this Manual. During this stage, a discussion with the Taxpayer should also be held, at the Office premises to gather information about the taxpayer and documenting the business systems or processes in use at his unit. The discussion with the taxpayer is intended to settle issues which can be cleared by simple discussion. This will help avoid

inclusion of non-issues in Audit Plan and expedite the audit process. Discussions with the Senior Management of the taxpayer are critical for developing a

meaningful audit plan. Keeping in mind the objective of gathering accurate and complete information, it may be useful not to conduct a formal interview, but to engage the taxpayer in informal discussions. At the same time, it is important to prepare points/ questions beforehand on which information is required. Important non-compliance issues derived from the profiles should also be discussed during the discussions and while gathering information from the taxpayer. Special emphasis should be placed on any organization or systemic changes that may have occurred since the last audit. Finally, an Audit plan for the Taxpayer should be prepared. The objective of desk review is to devise a focused audit plan. The proper desk review, preferably, under the supervision of a senior officer is vital for drawing up a meaningful audit plan.

The desk review is the most important step in the Audit and needs to be given more attention so that Audit Plan is a result of a more informed Desk Review. In order to achieve this, in addition to data already collected from the assessee, a questionnaire and certain data relating to reconciliation will also be obtained. On the basis of data received for reconciliation, a preliminary reconciliation will be done and the same will be available to the Auditors along with the questionnaire. After examining the data and the documents, an interview of the Authorized Representative of the assessee will be conducted so that doubts in the data and questionnaire are clarified and only those issues which cannot be clarified on the basis of reconciliation, questionnaire and interview with the assessee are referred in the Audit Plan. The interview could cover areas like the systems of purchase and purchase invoicing, the system of sale and sales invoicing, issues relating to registration (centralized registration, if any), the Information Technology (IT) systems used to process data, various returns submitted to third party regulatory organizations and also matters relating to Indian Standards Institute (ISI) quality certifications which would mean availability of certain important audit reports. In addition the following benefits would arise from this:

- i) Major issues will be discussed and examined at the level of Joint Commissioner/ Additional Commissioner conducting Desk Review.

ii) The period of visit by the Audit Party can be considerably shortened as there will be fewer and more precise Audit Points to verify.

iii) The Desk Review will pinpoint the important issues in Audit Plan

iv) No frivolous issues will be raised in Audit Plan.

v) The officer doing the Desk Review will be better aware of the facts

vi) After interview with the assessee no issues will be raised because of communication gap between the Department and the assessee.

vii) It will give incentive to assessee to come clean at Desk Review stage so that physical intervention of Audit Party at his premises is minimized.

There are three major areas which require attention during the Audit :-

i) The risk based on revenue earned on services provided by the assessee.

ii) The risk based on expenditure made on services received by the assessee.

iii) The risk based on CENVAT taken by the assessee.

The issues at S.Nos. i) & ii) would be identified by Revenue Reconciliation between the Books of Accounts and the Returns filed by the assessees. For this, the data is being called at the time of Desk Review itself. In order to streamline the reconciliation, a proforma for Reconciliation is being prescribed for both income and expenditure [ see ANNEXURE – VII ]. To standardize the Revenue Reconciliation, a detailed format is prescribed. There cannot be exhaustive format for Revenue Reconciliation. However, most commonly accruing entries have been taken care of. It is felt that all the receipts whether income or others needs to be tested for Service Tax liability. Therefore, reliance is being placed not only on the Balance Sheet but also on the gross Trial Balance of the assessee. In the Service Tax Law, the assessable value is based on various factors and care has been taken to incorporate most common factors in the format for Revenue Reconciliation. Similarly, on the expenditure side, there are certain expenditures which needs to be tested / checked. Therefore, the

corresponding entries in Trial Balance or Balance Sheet need to be reconciled with the figures given in the ST-3 Returns. These expenditures are Transportation

expenditure, Sponsorship expenditure in foreign currency other than these involved in purchase of goods etc.

#### **Guidelines for preparation of working papers**

1. After completion of each audit process, corresponding entries in the working papers should be made simultaneously. This would ensure that whatever is noticed is immediately documented instead of waiting for the completion of the entire audit to prepare the working papers.
2. Every step in the audit process must conclude with the remark on whether any point merits inclusion in the audit plan. The points in the audit plan would therefore represent the aggregation of all the important points identified in the various steps of the audit process.
3. The details of discussion with Joint/Additional Commissioner must be mentioned in the portion on desk review.
4. The details of the walk through done with respect to sample documents must be specifically stated in the portion on evaluation of internal control.
5. Training programmes should be conducted in-house by the Commissionerates and the Zonal units of the ADG (Audit) in coordination with NACEN for preparation of working papers.

**Trend Analysis:** Trend analysis is a type of computational support needed for the analysis preparatory to planning, by analysing historical data and working



out future projections. Historical data is analysed to discover patterns or relations that would be useful in projecting the future delivery and values etc.

For audit purposes either absolute values or certain ratios are studied over a period of time to see the trend and the extent of deviation from the average values during any particular period.

The auditor can study the following trends:-

1. Trends in service tax collection over the last two years.
2. Trends in service tax of a particular service industry compared to overall growth of that industry.
  
3. Trends in proportion of value of exempted services to the total value of services.

### 6.3 AUDIT PLAN

Audit Plan is the most important stage before taking up actual audit verification. At this stage, the auditor is in a position to take a reasonable view regarding potential risk areas, abnormal trends and unusual developments, which need detailed verification. Audit Plan is not a routine list of checks which can generally be exercised, but is an exact formulation of issues selected for detailed scrutiny in respect of a particular service provider based on the aforesaid desk review and risk analysis. Audit Plan should be a clear plan of action in a standard Format as given below:

Sl. No.	Subject	Issue to be Examined	Records to be seen	Period involved	Reasons for selection

It should be consistent with the scale of operation of a service provider as also the reasons for selection of a taxpayer in the Audit Schedule. How the issues are pin-pointed for an audit plan is illustrated below:-

- (i) Under-valuation of taxable service by excluding any specific component of gross amount charged for the service.
- (ii) Suspect discounts.
- (iii) Service Tax nomenclature involving non payment of tax on a service that may actually be taxable but is mis-declared or concealed as non taxable.
  
- (iv) Apportioning of value in favour of non-taxable or exempt services when composite, or multiple services are provided.
- (v) Possible leakage of revenue because of sub-contracting of a service or part thereof.
- (vi) Long pendency of provisional assessment.
- (vii) Disproportionate/ illegal availment of credit of duty/tax on input goods or services.

## **6.4 EVALUATION OF INTERNAL CONTROLS**

6.4.1 Internal Controls form a basis for reliability of the company's own accounting records. The evaluation of Internal Control is necessary for determination of the scope and extent of audit checks required for the taxpayer. If the internal controls are well designed and working properly, then it is possible to rely on the books maintained by him. The scope and the extent of the audit can be reduced in such a case. The reverse would be true if the internal controls are not reliable. In this regard, an auditor should normally examine the following:

- (i) Characteristics of the company's business and its activities.
- (ii) System of maintenance of records and accounts.
- (iii) Identifying the persons handling records for accounting purposes.
- (iv) Allocation of responsibilities at different levels.
- (v) System of internal checks.

- (vi) System of movement of documents having relation to Service Tax assessment.
- (vii) Inter-departmental linkages of documents and information.
- (viii) System of Service Provider's own internal audit.

#### 6.4.2 Techniques of evaluating the Internal Controls.

(a) **Walk-through:** One of the ways of evaluating internal control is to do a 'walk through'. This is done by selecting a few representative samples from different categories of transactions and examining them in depth, especially with regard to the procedural and control aspects. This can be done by reviewing key controls that prevent or detect the providing of services that are not invoiced. The system can be examined to ascertain whether it is possible for services to be invoiced but not recorded in the books of accounts. Similarly, key controls may be examined for recording of all cash transactions: these controls may include scrutiny of numbered cash transaction invoices, daily reconciliation of cash invoices, separation of taxes etc. Key controls may also be examined to detect the possibility of misclassification of services for the purpose of availing exemptions. The above steps may have to be undertaken by the auditor in the unit of the taxpayer. Undertaking a 'walk-through' and conducting ABC analysis during this process would help the auditor to evaluate the system of internal control in a scientific manner. In 'Walk-through' the auditor traces the movements of the selected transactions from the beginning through various sub systems. The auditor verifies this transaction in the same sequence as it had moved. By this method the auditor can get a feel of the various processes and their inter linkages. It is also useful method to evaluate the internal control system of a Service provider. The auditor for example can undertake a walk through of the business processes of a service provider so as to identify the points of collection of service tax and the points of billing of service charges. Similarly a walk through may be conducted on the process of compiling service tax returns in terms of its postings to the various financial documents.

(b) **ABC Analysis:** It is a known fact that in any field of activity an enormous data is generated and all data is not equally important. In order to filter out the irrelevant or relatively insignificant data, various techniques are applied. The ABC Analysis is one of such data management techniques. This technique is particularly useful when auditors are required to scrutinise and examine a large volume of

data/documents within a limited time period. In ABC analysis the whole data population is classified into three categories (i.e. A, B and C categories) based on the importance, as below

- A-category is the class of data that is most important from the point of view of managing and controlling the same.
- B-category is the class of data, which should invariably be controlled, but the degree of control is not as intense as for A-category.
- C-category is the class of data, which has far less revenue-implications and can be controlled by suitable test-checks.

The auditor can apply ABC Analysis especially in case the quantum of data/ information to be analysed is voluminous. In such a case auditor can classify them according to their utility towards potential risk into A, B and C categories. To give an example, transactions with top five customers/clients of a taxpayer may alone be taken up for detailed examination by auditors. Similarly while verifying credit utilization by the taxpayer, documents relating to the receipt/procurement of major input services may be examined. The technique of ABC analysis can also be suitably applied for evaluating the systems of internal controls while carrying out verification.

Some of the important ratios for auditor's use to analyze database are as below :

<u>Nature of Ratio / Method of calculation</u>	<u>Utility of the Ratios in Service Tax Audit and manner of use</u>	<u>Source Documents</u>
<p>Major inputs service cost : Value of Taxable Service (say A)</p> <p><i>Credit availed: Total Service Tax payable</i> (say B)</p>	<p>Compare the ratio over a period of 3-4 years. If the ratio is increasing there is possibility of the following irregularities:-</p> <p>i) Rendering of unaccounted output services. ii) Undervaluation of output services. iii) Diversion of output service income into non-taxable services income.</p> <p>Compare this ratio (A) with (B)</p> <p>If the ratio B is more than the ratio A, then there is possibility of wrong availment of credit either due to calculation mistake or the availment of credit on input services not being properly used in output services.</p>	<p>1. Profit &amp; Loss Account;</p> <p>2. Income &amp; Expenditure Account (in case of non profit organisations like clubs); and</p> <p>3. ST-3 return</p>
<p>Other incomes not charged to Service Tax : Value of taxable services</p>	<p>Compare the ratio over a period of 3-4 years or with the taxpayers rendering the same services.</p> <p>If the ratio is increasing over a period of time or it is more compared to other service providers, then there is a possibility of under valuation by splitting of output service income into non taxable / exempted service income.</p>	<p>1. Profit &amp; Loss Account;</p> <p>2. Income &amp; Expenditure Account (in case of non profit organisations like clubs); and</p> <p>3. ST-3 return</p>

<p>Additions to plant and machinery / fixed assets during the year : Total value of assets at the beginning of the year</p>	<p>A comparison of this ratio with the rate of growth of the value of taxable service during the year may be useful in verifying whether the value of taxable service has been correctly declared.</p> <p>It is particularly to be checked in cases where the additions to plant &amp; machinery / fixed assets directly impact the volume of sales.</p>	<p>Balance Sheet</p>
<p>Amount of credit availed on input services : Total Service Tax liability</p>	<p>Compare the ratio over a period of 3-4 years.</p> <p>If the ratio is increasing there is the possibility of the following irregularities:-</p> <p>(a) Rendering of unaccounted output services;</p> <p>(b) Under valuation of output services;</p> <p>(c) Splitting of output service income into non taxable services income.</p> <p>(d) Inflation of input service credit.</p>	<p>Tax Payer Profile; ST 3 return</p>
<p>Consumables / Fuel value : Value of taxable services</p>	<p>Compare this ratio over a period of 3-4 years or with the taxpayers rendering similar services.</p> <p>If the ratio is increasing over a period of time or if the ratio of the taxpayer is more than other service providers in the same industry, then there is a possibility of rendering of unaccounted output service or undervaluation of all the services.</p> <p>This ratio may be useful where consumables, fuel or power consumption are having relationship with the rendering of output services.</p> <p>This ratio may be used along with the ratio A, namely, Major input service cost : Value of taxable services, as discussed in first case above.</p>	<p>1. Profit &amp; Loss Account; and</p> <p>2. Income &amp; Expenditure Account (in case of non profit organisations like clubs)</p>

## **CHAPTER 7**

### **AUDIT VERIFICATION**

7.1 As discussed in earlier Chapters of this Manual, the focus of Audit has now shifted from visits to the premises of the Tax Payer to proper selection of taxpayers to be audited on the basis of some predefined criteria/ risk parameters, conduct of detailed Desk Review after collecting documents and information from the Tax Payer and preparation of detailed Audit Plan. The information available till the preparation of the Audit plan is analysed and entries are made in the Working Papers.

7.2 Audit Verification involves verification of data and actual verification of documents submitted at the time of Desk Review, verification of points mentioned in the Audit Plan, Walkthrough, evaluation of internal control, verification of CENVAT documents etc. While conducting Audit Verification, special care should be taken to examine all those issues pointed out in the Audit Plan. It needs to be ensured that all audit documentation are complete, accurate and of professional quality. Working Papers are a synopsis of audit operations conducted by the audit party. Format of the working papers is given in **ANNEXURE – VIII**. Entry in the working papers must be made during Audit Verification including all items mentioned in the audit plan. The auditor should conduct the verification in a systematic manner, following the sequence of steps envisaged in the Working Papers. While conducting Audit Verification, all the points mentioned in the Audit Plan must be checked thoroughly. If there is any additional point in the Audit Plan which is not there in the Working Papers, the same should be incorporated in the Working Papers. At the end of each entry in working papers, auditor must indicate the findings. If any of the planned verifications is not conducted, the reasons for the same must be recorded. Audit objections raised must be fully supported by documentary and legal evidence. This will greatly help in explaining and discussing the objections with the taxpayer and other follow up action.

Working papers should support the audit effort and results. They should:

- Be clear, concise, legible, organized, indexed, and cross-referenced;
- Disclose the audit trail and techniques used in the examination of each significant item;
- Support the conclusions reached and cover all queries raised; and
- Include audit evidence (e g., copy of a financial statement, an. invoice, a contract, a bank statement, a job-work agreement, etc.) to support the assessment.
- Link results to supporting working papers,e.g. the objections identified in the working papers must agree with the summary of audit results or statement of audit objections and the audit report.
- Audit reports need to be clear and disclose all material and relevant information.
- Follow up Action.

7.3 While conducting verification, the auditor should try to determine whether the apparent weaknesses in the internal control system of the service provider have led to any loss of revenue. He should also identify the procedural infractions on part of the taxpayer, which are recurrent in nature and which may obscure a significant fact. During the process, he must cross check the entries made by the taxpayer in various records and note discrepancies, if any. In all cases involving discrepancies, the auditor should make detailed enquiries regarding the cause of the discrepancies and their revenue implication.

7.4 The auditor should examine the documents submitted to various Government departments/ Regulatory Authorities such as Income Tax, Commercial Tax/ VAT, Banks, etc. by the taxpayer. This should be used in cross verification of the information filed by the taxpayer for the Service Tax assessment. Extensive use of information available with open sources such as electronic and print media, internet etc should also be resorted to for verification of information filed by the taxpayer.